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**FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY**

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February 8, 1999

EX PARTE

Ms. Magalie Roman Salas
Office of the Secretary
Federal Communications Commission
The Portals, 445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: SBC Communications Inc. and Ameritech
Corporation (CC Dkt. No. 98-141) and GTE Corporation and Bell
Atlantic Corporation (CC Dkt. No. 98-184)✓

Dear Ms. Salas:

On behalf of Sprint Communications Company L.P., and pursuant to a request of the FCC staff, I am submitting the written "Statement of Joseph Farrell" and "Statement of Professor Michael L. Katz." These statements were originally distributed at the FCC's February 5, 1999 "Roundtable of the Economics of Mergers Between Large ILECs" at which Professors Farrell and Katz participated as panelists.

Two copies of this letter are being submitted in each of the above-referenced dockets. If you have any questions please call me at (202) 429-4787.

Sincerely,



Michael Jones

Attachments

cc: Carol E. Matthey
To-Quyen Truong
Michael Kende
Radhika Karmarkar
William Dever
Janice Myles

Washington, DC
New York
Paris
London

STATEMENT OF JOSEPH FARRELL

**Before the Federal Communications Commission
Roundtable Discussion of ILEC Mergers
Washington, D.C.**

February 5, 1999

My name is Joseph Farrell. I am a Professor of Economics at the University of California at Berkeley. I served as Chief Economist of the Federal Communications Commission (FCC) in 1996 and 1997 and have advised the Department of Justice on antitrust policy. I believe that the pending mergers between Ameritech and SBC and between Bell Atlantic and GTE would hamper regulators' use of a key tool that helps make phone regulation more efficient.

In October of last year, on behalf of Sprint Communications Company, L.P., I co-authored a study with telecommunications expert Dr. Bridger Mitchell of how telephone regulators use comparative "benchmarking" across the big near-monopoly telephone companies and how this important tool is blunted by mergers among those companies. We reviewed the role of benchmarking both in traditional telecommunications regulatory activities (such as ratesetting and universal service) and in the active promotion of competition called for in the Telecommunications Act of 1996. As has been widely recognized in the United States and internationally, benchmarking is a powerful and beneficial tool in a wide variety of such contexts. For example, regulators can use experience in other jurisdictions to set service quality standards, or can require all companies to adopt the best practices for connecting to competitors' networks.

Our study showed how benchmarking puts large telephone companies into competition-by-comparison even if they do not compete directly for each other's customers. The proposed mergers would reduce this kind of competition, in much the

same way as a merger between firms that compete to sell products to the same customers reduces regular competition.

Comparing regulated firms' performance against each other is a "used and useful" technique for ensuring that consumers and competitors get a fair deal while encouraging the monopolies to operate efficiently. However, when the number of large local telephone companies goes from eight to six to four, those comparisons inevitably get weaker and more tentative. Then regulators either have to give the firms a lot of slack, which would be premature given the slow growth of real local phone competition, or else clamp down in traditional green-eyeshade regulatory ways that are liable to retard innovation and productivity growth.

Our study also considered that private firms can and do compare ILECs against one another. Customers and suppliers of complements (such as long distance companies), as well as nascent competitors, will "benchmark" the ILECs' proposals and performances to produce more efficient outcomes.

Mergers among large ILECs significantly weaken the power and effectiveness of benchmarking. Until 1996 there were seven regional Bell companies plus GTE; mergers between SBC and PacBell and between Bell Atlantic and Nynex have already taken place. The loss of even one of the relative handful of large ILECs would substantially damage efficient regulation, including the interconnection regulation necessary for the growth of competition in local exchange markets.

STATEMENT OF PROFESSOR MICHAEL L. KATZ

FCC ROUNDTABLE ON THE ECONOMICS OF MERGERS BETWEEN LARGE ILECS

5 February 1999

I. INTRODUCTION

My name is Michael L. Katz. I am the Edward J. and Mollie Arnold Professor of Business Administration at the University of California at Berkeley. I hold a joint appointment in the Haas School of Business Administration and the Department of Economics. I serve as the Director of the Center for Telecommunications and Digital Convergence at the University of California at Berkeley. I specialize in the economics of industrial organization, which includes the study of antitrust and regulatory policies. I regularly teach courses on microeconomics, business strategy, and telecommunications policy. In addition to my academic experience, I have served as a consultant to both the U.S. Department of Justice and the Federal Communications Commission (the Commission) on issues of public policy in telecommunications markets. In 1994 and 1995, I served as Chief Economist of the Commission. In this statement, I examine how, if allowed, the proposed mergers between large ILECs would increase both the abilities and incentives of these carriers to weaken competition.

II. THE PROPOSED ILEC MERGERS POSE SIGNIFICANT THREATS TO TELECOMMUNICATIONS COMPETITION

This section briefly outlines the factual and logical analyses underlying the conclusion that the proposed mergers pose significant threats to telecommunications competition and thus to the public interest. Harm to *competitors* is not the source of harm to the public interest. Rather, by raising rivals' costs and degrading their ability to offer high-quality and innovative services, the mergers will weaken *competition*, and telecommunications consumers will be harmed.

- **Incumbent ILECs possess significant market power in the provision of access services to their actual and potential rivals.** Local and long distance competitors depend on ILEC access services, including unbundled network elements, interconnection (both at the network and OSS levels), and various forms of originating and terminating access services. Competitors will need an array of new and innovative forms of access in the future. ILEC market power may be exercised by setting high access prices (in the absence of price regulation) or by pursuing exclusionary access policies that deny, delay, or degrade the access provided to competing carriers.
- **Regulation is an imperfect check on the exercise of ILEC market power.** At best, regulation is a slow and imperfect process. These limitations reflect the difficult nature of the regulator's problem. The roll out of xDSL offers several examples of how it is hard to distinguish ILEC misdeeds from difficulties inherent in implementing new technologies. In part by weakening benchmarks, the proposed merger would make it even more difficult for state and federal policy makers to prevent ILECs from refusing to provide efficient, high-quality and innovative access at reasonable prices.
- **Exercise of ILEC market power in the provision of access will significantly weaken competition.** Local and long distance carriers will continue to depend on ILEC access services to compete. ILEC conduct that impairs rivals' quality, raises their costs, or slows their entry or expansion harms the public interest. Consumer welfare is reduced even if ILEC practices do not completely drive the rivals from the market.
- **There are significant competitive spillovers across ILEC regions.** This conclusion follows from two key facts. First, national rivals are the strongest competitive threats to the ILECs. Second, there are significant benefits to national scope, so that weakening a rival's ability to compete in one region will weaken its ability to compete in other regions as well. These effects arise due to the presence of:
 - Network effects at the subscriber level.
 - Network effects at the third-party supplier level.
 - Word-of-mouth networks.
 - Economies of scale and scope.
- **The proposed ILEC mergers would increase the merging parties' incentives and abilities to exercise their market power.** By permitting effective coordination between what are today separate and independent local exchange operations, the proposed ILEC mergers would increase the merging parties' incentives and abilities to disadvantage local and long distance rivals by reducing ILECs' provision of the high-quality, efficient, and innovative forms of access that competitors will require.

The proposed mergers thus pose significant threats to telecommunications competition and the public interest.

III. MERGER PROPONENTS HAVE RAISED INVALID OBJECTIONS TO THIS ANALYSIS

The parties have put forth several claims that do not stand up to logical or factual scrutiny. Here, I only have time to hit on some of the highlights:

- The ILECs claim that if consumers and rivals can observe poor performance, then so can regulators. But the question is not whether ILEC performance is observable; the question is whether regulators can distinguish strategic behavior from technical limitations from plain old incompetence. For example, CLEC-ILEC OSS interfaces perform worse than ILEC internal OSS interfaces. Is this inherent in current technology and systems, or is it due to ILEC strategic behavior? The fact is that ILECs have scope to engage in anticompetitive behavior.
- The ILECs claim that, once the costs of entry have been sunk, a rival's competitive behavior cannot be affected. The fact is that an ILEC has incentives to engage in anticompetitive behavior against a current rival to: (a) deter additional investment by that rival, or (b) deter future entry by additional carriers. Indeed, sunk costs make entry riskier and can increase the power of ILEC exclusionary behavior.
- The ILECs claim that competitive spillovers across ILEC regions are negative because deterring entry in one region increases the threat of entry in other regions. The fact is that the most significant players are planning national coverage. Carriers are doing this in order to develop network effects, offer geographic one-stop shopping, use national media, and enjoy economies of scale in systems development. Weakening these rivals in one region weakens them overall and reduces the threat of entry and competition faced by ILECs in other regions.
- The ILECs claim that regulation works so well that there is no scope to engage in exclusionary behavior. The fact is that numerous instances at the state and federal levels demonstrate that ILECs can and do attempt to slow competition. These instances may be only the tip of the iceberg. Presumably the fact that ILECs try indicates that they believe they have a chance of getting away with it. The ILECs also make a variant of this argument when they claim that the interLATA carrot deters bad behavior. But one only has to look at the state of §271 applications to see that this argument doesn't hold water: the RBOCs have not been given sufficient incentives to induce compliance with the checklist to date. This is not entirely surprising: the data show that local margins are large relative to long distance margins for business lines. Thus, the prospect of interLATA authority cannot be expected to eliminate RBOC exclusionary behavior.